CALIFORNIA STATE AUDITOR

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STATE AUDITOR

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Independent Auditor's Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2004, which collectively comprise the State of California's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of California's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 41 percent, and 50 percent, respectively, of the assets, net assets and revenues of the business-type activities.

- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 76 percent, 89 percent, and 75 percent, respectively, of the assets, net assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.

- Certain nonmajor enterprise funds that represent 70 percent, 45 percent, and 81 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System, State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 91 percent, 92 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.

- The discretely presented component units noted above.

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Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as it relates to the amounts included for those funds and entities, are based on the reports of the other auditors.

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

The financial statements of the State Compensation Insurance Fund (SCIF) have not been audited, as discussed in Note 1, and we were not engaged to audit the SCIF financial statements as part of our audit of the State of California's basic financial statements. SCIF's financial activities are included in the State of California's basic financial statements as a discretely presented component unit and represent 24 percent, 9 percent, and 24 percent of the assets, net assets, and revenues, respectively, of the State of California's aggregate discretely presented component units.

In addition, as discussed in Note 1, management has not included the California Earthquake Authority (CEA) in the State of California's financial statements. Accounting principles generally accepted in the United States of America require the CEA to be presented as a discretely presented component unit and financial information about the CEA to be part of the aggregate discretely presented component units, thus increasing the component units' assets, liabilities, revenues, and expenses, and changing its net assets. The amount by which this departure would affect the assets, liabilities, net assets, revenues, and expenses of the State of California's aggregate discretely presented component units is not reasonably determinable.

In our opinion, because of the omission of the CEA, as discussed above, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the CEA of the State of California as of June 30, 2004, or the changes in the financial position thereof for the year then ended.

In addition, in our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had SCIF's financial statements been audited, and the effects of not including financial information for the CEA as part of the aggregate discretely presented component units, as described above, the financial statements referred to above present fairly, in all material respects, the financial position of the aggregate discretely presented component units for the State of California, as of June 30, 2004, and the changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Further, in our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State of California, as of June 30, 2004, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, reports on the State's internal control structure and on its compliance with laws and regulations will be issued in our single audit report. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis on pages 7 through 25, and schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances and related notes on pages 138 through 146 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The combining financial statements listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining financial statements have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections of this report have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we express no opinion on them.

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Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

January 28, 2005

NOTE 3: DEPOSITS AND INVESTMENTS

The State reports investments at fair value. State statutes authorize investments in certain types of securities. The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). There is a single portfolio of investments, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below. In addition, certain funds have the authority to separately invest their cash.

A. State Treasurer's Pooled Investment Program

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to have investments in United States government securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, mortgage loans and notes, other debt securities, repurchase agreements, reverse repurchase agreements, equity securities, real estate, mutual funds, and other investments.

The State Treasurer's Office administers a pooled investment program for the primary government and for certain discretely presented component units. As of June 30, 2004, the discretely presented component units' cash and pooled investments were approximately 7.1% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. The State Treasurer's Office maintains cash deposits with certain banks where the income earned on the deposits compensates the banks for services and uncleared checks that are deposited in the pooled investment program's accounts.

All demand and time deposits held by financial institutions as of June 30, 2004, totaling approximately $7.1 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or an agent of the State Treasurer's Office in the State's name. The California Government Code requires collateral pledged for demand and time deposits to be deposited with the State Treasurer.

As of June 30, 2004, the State Treasurer's Office had amounts on deposit with a fiscal agent totaling $31 million related to principal and interest payments to bondholders. Additionally, there was $36 million in a compensating balance account with a custodial agent, which was designed to provide sufficient earnings to cover fees for custodial services. Most of these deposits are insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of all securities in the State Treasurer's pooled investment program is based on quoted market prices. As of June 30, 2004, the average remaining life of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 209 days.

The Pooled Money Investment Board provides regulatory oversight over the State Treasurer's pooled investment program. The purpose of the board is to design an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The Pooled Money Investment Board is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board designates the amounts of temporarily idle money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2004, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

Certain funds have elected to participate in the pooled investment program, even though they have the authority to make their own investments. Others may be required by legislation to participate in the program. As a result, the deposits of these funds or accounts may be considered involuntary. However, these funds or accounts are part of the State's reporting entity. The remaining participation in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, the earnings are legally required to be assigned to the State's General Fund. Most of the $123 million in interest revenue received by the General Fund from the pooled investment program in the 2003-04 fiscal year was earned on balances in these funds.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This method differs from the fair value method used to value investments in these financial statements, because the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements.

The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

The fair value and the ranges of interest rates and maturity dates of each major investment classification in the State Treasurer's pooled investment program are summarized in Table 1, which follows.

As of June 30, 2004, asset-backed securities comprised slightly more than 1.6% of the pooled investments. There were no floating-rate notes held at year-end. For floating-rate notes held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio was such that it hedged the portfolio against the risk of increasing interest rates. A significant portion of the asset-backed securities consists of mortgage-backed securities, which are called real estate mortgage investment conduits (REMICs). A REMIC is a security backed by a pool of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule.

The California Government Code allows the State Treasurer's Office to enter into repurchase agreements as part of its pooled investment program. A repurchase agreement consists of two simultaneous transactions. One is the purchase of securities by the State Treasurer's Office from a bank or dealer. The other is a commitment by the bank or dealer to repurchase the securities from the State Treasurer's Office at the same price, plus interest, at a mutually agreed-upon date. As the investor, the State is protected by underlying specific government securities, which are pledged as collateral during the length of the investment. During the year ended June 30, 2004, the State Treasurer's Office entered into 28 repurchase agreements, with a carrying value of approximately $4.7 billion. As of June 30, 2004, the State Treasurer's Office did not have any repurchase agreements outstanding.

The California Government Code allows the State Treasurer's Office to enter into reverse repurchase agreements as part of its pooled investment program. A reverse repurchase agreement is a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The fair value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in the fair value of the securities. If the dealers defaulted on their obligations to resell these securities to the State Treasurer's Office or to provide securities or cash of equal value, the State Treasurer's pooled investment program would suffer an economic loss equal to the difference between the fair value plus the accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the year ended June 30, 2004, the State Treasurer's Office entered into six reverse repurchase agreements by temporarily selling investments with a carrying value of approximately $1.0 billion. The maturities of investments made with the proceeds from reverse repurchase agreements are matched to the maturities of the agreements. As of June 30, 2004, the State Treasurer's Office did not have any reverse repurchase agreements outstanding.

Table 1 presents the primary government's investments by credit risk category.

Table 1

Schedule of Investments – Primary Government
June 30, 2004
(amounts in thousands)

	Interest Rates*	Maturity	Credit Risk Category 1	2	3	Total Fair Value**
Pooled investments* **						
U.S. government securities	0.95 – 3.31	1 day – 5 years	$ 23,492,502	$ —	$ —	$ 23,492,502
Negotiable certificates of deposit	1.05 – 1.76	1 day – 1 year	9,279,115	—	—	9,279,115
Commercial paper	1.00 – 1.39	1 day – 180 days	11,140,253	—	—	11,140,253
Corporate bonds	1.73 – 2.94	1 day – 3 years	1,623,969	—	—	1,623,969
Bank notes	1.05 – 1.76	1 day – 1 year	1,224,249	—	—	1,224,249
Total pooled investments			**46,760,088**	**—**	**—**	**46,760,088**
Separately invested funds subject to categorization						
Equity securities			181,787,583	3,075	—	181,790,658
Securities lending collateral			51,648,240	—	—	51,648,240
Mortgage loans and notes			30,871,935	37,380	—	30,909,315
U.S. government and agencies			16,370,948	346,961	—	16,717,909
Commercial paper			2,178,361	—	—	2,178,361
Corporate bonds			12,881,774	126,301	—	13,008,075
Other investments			6,308,305	30,013	—	6,338,318
Total separately invested funds subject to categorization			**302,047,146**	**543,730**	**—**	**302,590,876**
Separately invested funds not subject to categorization						
Investments held by broker-dealers under securities loans with cash collateral						50,955,156
Real estate						18,721,741
Venture capital and private equity funds						618,041
Investment contracts						2,751,707
Mutual funds						5,080,899
Insurance contracts						443,271
Mortgage loans						293,527
Other investments						14,626,070
Total separately invested funds not subject to categorization						**93,490,412**
Total investments			**$ 348,807,234**	**$ 543,730**	**$ —**	**442,841,376**
Fiduciary fund investments						
Less: investment trust fund						22,013,079
Less: private purpose trust funds						1,418,943
Less: pension and other employee benefit trust funds						390,898,394
Total government-wide investments						**28,510,960**
Less: current government-wide investments						26,133,646
Total noncurrent government-wide investments						**$ 2,377,314**

* These interest rates represent high and low monthly averages for each investment type during the year.
** Investments are reported at fair value except for $182 million for investment contracts that are reported at cost in two enterprise funds.
*** Approximately 7.1% of the pooled investments are investments of discretely presented component units. For separately invested funds of discretely presented component units, see Table 2.